United States General Accounting Office

GAO

Briefing Report to Congressional Requesters

July 1989

DAIRY IMPORTS

Issues Related to Chocolate Products

GAO/RCED-89-159BR

GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-230319

July 18, 1989

The Honorable Lloyd Bentsen
Chairman, Committee on Finance
United States Senate

The Honorable Patrick J. Leahy
Chairman, Committee on Agriculture,
Nutrition, and Forestry
United States Senate

The Honorable E (Kika) de la Garza
Chairman, Committee on Agriculture
House of Representatives

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
House of Representatives

Section 4507 of the Omnibus Trade and Competitiveness Act of 1988 requires us to study the possible circumvention of agricultural quotas on articles containing sugar and dairy products. Our June 22, 1988, report fulfills the act's requirement regarding the sugar issue.[1] This briefing report fulfills the requirements regarding the dairy issue.

As agreed with your offices, this report addresses dairy products--primarily dry whole milk--contained in imported chocolate block of 10 pounds or more. (Appendix I provides the import volume of other selected dairy products as well.) Increased imports of chocolate block have caused concern among some domestic dairy groups who believe that the dry whole milk contained in the block displaces U.S.-produced milk and interferes with the U.S. Department of Agriculture's (USDA) dairy price support program.[2]

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[1] Sugar Program: Issues Related to Imports of Sugar-Containing Products (GAO/RCED-88-146, June 22, 1988).

[2] USDA's Commodity Credit Corporation purchases certain excess dairy products to support the price of U.S.-produced milk, but dry whole milk is not one of the products covered by the dairy price support program.

This report addresses, among other things, (1) changes in the volume of imported chocolate block in recent years, and the relationship of the dry whole milk contained in the block to domestic dry whole milk production and the dairy price support program; (2) efforts undertaken by the U.S. Customs Service to enforce dairy limits in imported chocolate block; (3) the status of requests by two dairy groups for an investigation of whether imported chocolate block materially interferes with the dairy price support program; and (4) use of Foreign Trade Zones to bring imported chocolate block and dry whole milk into the United States. On March 14, 1989, we briefed your offices on the information included in this report.

In summary, we found the following:

-- In recent years, imported chocolate block has increased more than 1,600 percent--from 3.8 million pounds in 1978 to 67.4 million pounds in 1988. This increase has resulted for several reasons, including the use of lower-priced foreign sugar and dairy ingredients.

-- Chocolate block, a nontariff, nonquota import item, is allowed to contain up to 32 percent milk solids, usually dry whole milk, but generally it contains less than the allowable amount.[3] For example, in 1988, on the basis of information we obtained from importers, about 28 percent of the imported chocolate block contained no dry whole milk, while about 31 percent contained about 22 percent dry whole milk. Using these percentages and other assumptions, we estimate that the amount of dry whole milk contained in imported chocolate block in 1988 could have ranged from 4.8 million pounds to 13.3 million pounds, representing a range from about 3 to 8 percent of the domestic dry whole milk production. Further, if all of the dry whole milk contained in imported chocolate block interfered with the dairy price support program, we estimate that imported chocolate block in 1988 could have cost the program from $4.1 million to $11.4 million (or about 0.3 to 1 percent) in additional purchases. (See sec. 2.)

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[3]Since 1952, there has been an annual import quota on dry whole milk of 7,000 pounds. That quota does not apply to the dry whole milk contained in imported chocolate block.

- -- Customs Service conducts limited laboratory analyses on samples of imported chocolate block for a variety of reasons, including to determine whether the samples exceed the established 32-percent milk content limit. From fiscal year 1980 to mid-April 1989, Customs Service records indicate that 101 shipments (2 percent of the total 5,365 chocolate block shipments) were sampled. Of the 70 laboratory reports readily available to us, six samples exceeded the milk content limit. According to Customs Service officials, those six samples, which were taken prior to fiscal year 1982, led to the classification of the shipments as items other than chocolate block or to retesting, wherein the milk solids were found to be within acceptable limits. None of the six samples were taken from the two ports included in our review, where about 60 percent of the imported chocolate block entered the United States in 1988. Customs Service does not consider imported chocolate block a high-risk item for extensive inspection and laboratory analysis. However, because of recent congressional interest, visual inspection and sampling have increased since 1988. (See sec. 3.)

- -- Section 22 of the Agricultural Adjustment Act authorizes the Secretary of Agriculture to recommend that the President initiate a U.S. International Trade Commission investigation to determine whether an import materially interferes with the dairy price support program. In 1987 and 1988, two dairy groups requested that the Secretary use that authority to initiate an investigation of imported chocolate block. USDA has not initiated the requested investigation, although agency officials state that they are continuing to review the issue, focusing on the sugar rather than the dairy content of the chocolate block because imported chocolate block can contain mostly sugar, by weight. (See sec. 4.)

- -- Foreign Trade Zones are specially designated areas (zones) within the United States. The goal of the Foreign Trade Zones is to expedite and encourage U.S. participation in international trade by allowing companies to store, mix, manufacture, or perform other operations using foreign goods without subjecting them to formal customs entry. If the goods in the zones subsequently enter customs territory, they are subject to applicable tariffs and quotas, but if the goods are exported, they are not subject to tariffs and quotas.

In 1987 and 1988, about 87,000 pounds of chocolate block and 6,500 pounds of dry whole milk were sent into Foreign Trade Zones. However, none of it would have been subject to applicable U.S. tariffs and quotas. Because imported chocolate block is not subject to tariffs and quotas anywhere in the United States, there are no restrictions on sending it into zones. Regarding the 6,500 pounds of dry whole milk, a Foreign Trade Zones Board official told us that the entire amount had been mixed with other ingredients and exported. (See sec. 5.)

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We conducted our work from September 1988 through April 1989. Our information was obtained primarily from officials of the USDA, International Trade Commission, Customs Service, Bureau of Census, and Foreign Trade Zones Board. We also interviewed and obtained information from officials of dairy and chocolate organizations, as well as from the largest importers of chocolate block. Because no federal agencies compiled and summarized the milk content of all imported chocolate block and because of the proprietary nature of the records of individual importers, we did not independently determine the dairy content of all chocolate block. (See sec. 1.)

We discussed the results of our work with officials from the agencies and groups covered in this report. However, as agreed with your offices, we did not obtain written agency and industry comments on this report. We plan to distribute this briefing report today to the Secretary of Agriculture; Administrator of the Foreign Agricultural Service; Commissioner of the U.S. Customs Service; Commissioners of the U.S. International Trade Commission; Director, Office of Management and Budget; and other interested parties. This work was performed under the direction of John W. Harman, Director, Food and Agriculture Issues. If you have any questions, please contact him at (202) 275-5138. Major contributors to this briefing report are listed in appendix II.

J. Dexter Peach
Assistant Comptroller General

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ABBREVIATIONS

CCC	Commodity Credit Corporation
FAS	Foreign Agriculture Service
GAO	General Accounting Office
RCED	Resources, Community, and Economic Development Division
USDA	U.S. Department of Agriculture

SECTION 1

INTRODUCTION

..CKGROUND: SUMMARY

- Since 1953, quotas have been imposed on virtually all imports of dairy products, including dry whole milk.
- Imported chocolate block, containing 0 to 32 percent dry whole milk, is a concern to some dairy groups who believe the increased import materially interferes with the dairy price support program. There is no quota on imported chocolate block, regardless of whether it does or does not contain dry whole milk.
- Section 22 of the Agricultural Adjustment Act, as amended, authorizes the President to direct the U.S. International Trade Commission to investigate whether imported agricultural products interfere with the U.S. dairy price support program or adversely affect domestic production.

OBJECTIVES, SCOPE, AND METHODOLOGY: SUMMARY

- Our objectives were to address
  - changes in the volume, pattern, and composition of imported chocolate block;
  - Customs Service's efforts to enforce the dairy limit in chocolate block;
  - results of requests for a section 22 investigation of chocolate block; and
  - the use of foreign trade zones to bring chocolate block and dry whole milk into the United States.
- To accomplish these objectives, we interviewed federal officials who administer and investigate dairy imports and quotas, and industry representatives. Also, we obtained documentation pertinent to the scope of our work, including statistical data we used to estimate the effects of imported chocolate block on domestic dairy production.

BACKGROUND

In the mid-1950s, quotas were imposed under section 22 of the Agricultural Adjustment Act on most imported dairy products, including dry whole milk. Since 1982, the volume of one imported item that may contain dry whole milk but is not under a quota--chocolate in blocks of 10 pounds or larger--has increased.[1] This increase has caused concern about whether the importation of chocolate block has (1) been used to avoid the quota for dry whole milk or (2) interfered with the dairy price support program.

The price support program is administered by the Commodity Credit Corporation (CCC), U.S. Department of Agriculture (USDA). CCC supports the price of milk through purchases of excess domestic butter, cheese, and nonfat dry milk. While CCC does not purchase dry whole milk, two dairy groups contend that the import of dry whole milk in chocolate block is displacing U.S.-produced milk and leading to additional CCC purchases. These dairy groups have taken the position that imported chocolate block is materially interfering with the dairy price support program and, therefore, a quota should be placed on it.

SECTION 22 OF THE AGRICULTURAL ADJUSTMENT ACT AND DAIRY QUOTAS

Section 22 of the Agricultural Adjustment Act, as amended, authorizes the President, on advice of the Secretary of Agriculture, to direct investigations of imports of agricultural products. These investigations are to determine whether articles are being imported or are practically certain to be imported into the United States under such conditions and in such quantities as (1) to render ineffective or materially interfere with the agricultural price support programs or (2) to reduce substantially the amount of any agricultural product processed in the United States.

The President directs the U.S. International Trade Commission to conduct section 22 investigations. The International Trade Commission is an independent federal agency that furnishes studies, reports, and recommendations involving international trade and tariffs to the President, the Congress, and other government

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[1] For the remainder of this report, the term "chocolate block" will refer to sweetened chocolate in blocks weighing 10 pounds or more. Chocolate block had been classified as Item 156.25.00 under the Tariff Schedules of the United States, Annotated. In January 1989, a new tariff schedule, the Harmonized Tariff Schedule of the United States, went into effect, changing the tariff schedule item for block to 1806.20.20 and changing the description to "blocks of 4.5 kilograms or more."

agencies. In conducting its investigations, the Commission may distribute and obtain responses to questionnaires, gather information from testimony at public hearings and other sources, and interview industry and government parties to obtain data pertinent to the imported article being studied. The results of such investigations are analyzed by the Commissioners and reported with findings and recommendations to the President. Under section 22, the President has the authority to impose fees not exceeding 50 percent ad valorem on imports found to interfere with a price support program, or to impose specific quotas. If warranted, the Secretary can also recommend that the President take immediate action pending the results of an investigation by the Commission. However, the President is not obligated to take any action based on the recommendations of the Commissioners or the Secretary.

Since 1953, quotas have been imposed under the provisions of section 22 of the Agricultural Adjustment Act on virtually all imported dairy products. However, these quotas do not apply to chocolate block. The quotas were imposed to protect the USDA dairy price support program from import interference or threat of interference. The quotas for dairy products are provided for in the U.S. International Trade Commission's Harmonized Tariff Schedule of the United States. Currently, for example, there are annual quotas of about 244 million pounds on cheese, 707,000 pounds on butter, 1,807,000 pounds on nonfat dry milk, and 7,000 pounds on dry whole milk.

USDA administers most quotas on dairy products through a system of import licenses. The quotas for products not subject to licensing are allocated on a first-come, first-served basis by the Department of the Treasury's Customs Service. The Customs Service is also responsible for monitoring imports of articles with quota licenses from USDA.

THE DAIRY AND CHOCOLATE INDUSTRY

Domestically produced milk not used for drinking purposes is generally processed into manufactured dairy products. About three-fourths of the supply of milk used for manufactured dairy products is used for producing cheese, butter, and nonfat dry milk. The rest is made into other products, such as dry whole milk used by the chocolate industry.

The largest use of milk by the chocolate and confectionery industry is for manufacturing milk chocolate. Two major forms of milk in chocolate include sweetened condensed and dry whole milk. According to industry experts, if dry whole milk is used, it typically makes up 12 to 25 percent, by weight, of milk chocolate.

Chocolate Block

The ingredients in chocolate block vary, depending on the end use of the block. Chocolate in blocks of 10 pounds or more can contain a mixture of sugar, cocoa, and from 0 to 32 percent nonfat milk solids and butterfat. Imported chocolate block is normally solidified in large drums or packaged in boxes before being transported into the United States. In recent years, the majority of chocolate block has entered the United States from Canada. Chocolate block is considered by chocolate manufacturers to be an intermediate product, not a finished product for retail sale. Frequently, but not in all cases, imported chocolate block is further refined and sold to other industries, such as confectioners, where it is ultimately used in consumer products.

OBJECTIVES, SCOPE, AND METHODOLOGY

Section 4507 of the Omnibus Trade and Competitiveness Act of 1988 requires us to study the possible circumvention of agricultural quotas on articles containing sugar and dairy products. Our report Sugar Program: Issues Related to Imports of Sugar-Containing Products (GAO/RCED-88-146, June 22, 1988) fulfilled the requirement to examine the sugar issue. The act stated that we were to report our results to the Committee on Agriculture, Nutrition, and Forestry and the Committee on Finance, U.S. Senate; and the Committee on Agriculture and the Committee on Ways and Means, House of Representatives.

On the basis of our discussions with each of the Committee offices, we agreed to fulfill our statutory requirement by determining the impact that imported chocolate block of 10 pounds or more has on the dairy price support program and the dairy industry. We did not examine the possible impact on consumers. We concentrated on chocolate block because it was the one item for which USDA was requested by the dairy industry to recommend a section 22 investigation. Also, among five items cited by the dairy industry for possible interference with the dairy price support program, chocolate block potentially contained the largest amount of nonquota milk products, except for casein.[2] The import volumes of the five items cited is included as appendix I.

We agreed with the Committees that the approach to meeting the objectives in the act would address (1) changes in the volume, pattern, and composition of imported chocolate block, and the

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[2]The Commission performed a section 22 investigation on casein, the principal protein in milk, in 1982. The Commission concluded that casein did not materially interfere with the price support program for milk, nor did it substantially reduce the amount of any product processed in the United States from domestic milk.

relationship of the dry whole milk contained in the block to domestic dry whole milk production and the dairy price support program; (2) efforts undertaken by the U.S. Customs Service to enforce the dairy limit in chocolate block; (3) results of the requests by dairy groups for a section 22 investigation of chocolate block because of its dairy content; and (4) use of Foreign Trade Zones to bring imported chocolate block containing dairy products into the United States.

To address these objectives overall, we interviewed responsible federal officials and industry representatives. In general, we were unable to verify their statements because (1) federal agencies did not compile the data we required, such as the dairy content of all imported chocolate block, and (2) importers considered their records to be confidential business information. To determine the volume, pattern, and composition of imported chocolate block and the relationship of dry whole milk in imported chocolate block to the domestic dry whole milk production and the dairy price support program, we interviewed and obtained information from the following federal agencies: USDA's Foreign Agricultural Service, Economic Research Service, and Agricultural Stabilization and Conservation Service; the U.S. Department of the Treasury's Customs Service; the Department of Commerce's Bureau of Census; and the U.S. International Trade Commission. We also interviewed and obtained information from representatives of the American Dairy Products Institute and the National Milk Producers Federation because they had requested a section 22 investigation of the dairy content of imported chocolate block. In addition, we interviewed and obtained information from representatives of various organizations that we were told were familiar with the dairy content in imported chocolate block, including three chocolate importers; the Chocolate Manufacturers' Association; the Cocoa Merchants Association of America, Inc.; a domestic chocolate manufacturer who was not an importer of chocolate block; and a producer of dry whole milk. On the basis of this information, we made certain assumptions about the dairy content of chocolate block and whether its dairy content displaced domestically produced dry whole milk. We did not evaluate the impact of imported chocolate block on consumers. (See sec. 2).

To determine the efforts undertaken by the U.S. Customs Service to enforce quantitative limits, we interviewed and obtained information from the U.S. Department of the Treasury's Customs Service headquarters office and its district offices in Detroit, Michigan, and St. Albans, Vermont, where most of the chocolate block enters the country. To determine the results of the requests for a section 22 investigation of chocolate block, we interviewed and obtained information from USDA's Foreign Agricultural Service and from the American Dairy Products Institute and the National Milk Producers Federation, who made the requests. To examine the use of Foreign Trade Zones for bringing chocolate block and dry whole milk into the United States, we interviewed and obtained information from officials of the Department of Commerce's Foreign Trade Zones Board and the Bureau of the Census. We conducted our field work from September 1988 through March 1989. We did not obtain written agency and industry comments.

SECTION 2

CHANGES IN THE PATTERN, VOLUME, AND COMPOSITION OF IMPORTED CHOCOLATE BLOCK

SUMMARY

- Chocolate block imported into the United States has generally increased in recent years, but not all of it contains dairy products.

- We estimated that imports of chocolate block into the United States contained the equivalent of 4.8 million to 13.3 million pounds of dry whole milk in 1988. The annual import quota of 7,000 pounds on dry whole milk does not apply to mixtures such as chocolate block.

- Chocolate block importers and dairy organizations provide various reasons for the increased chocolate block imports. These reasons include

  -- savings from purchasing the ingredients at world prices,

  -- assured availability to world supplies by mixing ingredients outside the United States,

  -- savings created by importing a tariff-free product,

  -- advantages associated with special production factors between U.S. and foreign facilities, and

  -- increase in U.S. production of retail chocolate items.

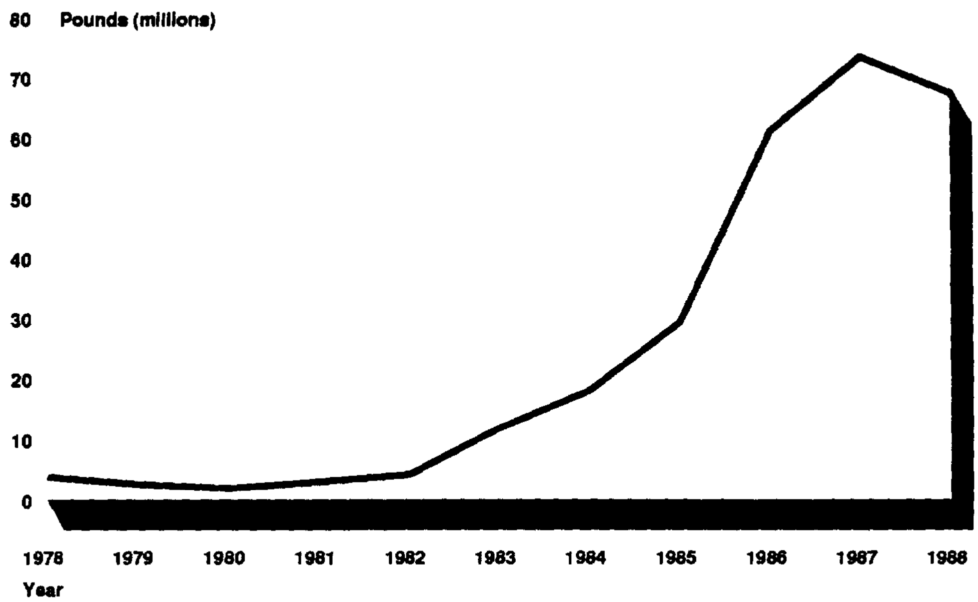
- Several domestic dry whole milk producers claim that they have lost sales because of the increase in chocolate block imports.

- Using certain assumptions, we estimate that the additional cost to CCC in 1988 could have ranged from $4.1 million to $11.4 million, which is about 0.3 to 1 percent of all milk equivalent purchases by CCC for that year.

IMPORTS OF CHOCOLATE BLOCK
HAVE INCREASED

The amount and pattern of imports of chocolate block have changed in recent years. Figure 2.1 shows that since 1978 the import of chocolate block has increased by 1,674 percent, ranging from 3.8 million pounds in 1978 to 67.4 million pounds in 1988. The increase in this imported item, which began to move rapidly in 1982, peaked in 1987 at 73.4 million pounds.

Figure 2.1: Trend in the Import of Chocolate Block



Source: Compiled from Bureau of Census data.

The historical pattern of foreign countries exporting chocolate block into the United States has also changed in recent years. Before 1984, the amount of chocolate block imported from Canadian ports was less than 2 percent of all the chocolate block imported. Between 1984 and 1988, however, imports from Canada increased, and they now account for over 70 percent of all the chocolate block imported. In the mid-1980s, two companies began making chocolate block in Canada and sending it to the United States. Other suppliers of imported chocolate block to the United States include Brazil, Belgium, and Finland.

In 1988, about 60 percent of the imported chocolate block entered the United States through two ports of entry--Detroit, Michigan, and St. Albans, Vermont. The remaining 40 percent of the imported chocolate block entered through 14 other U.S. ports.

NOT ALL IMPORTED CHOCOLATE BLOCK CONTAINS MILK PRODUCTS

Imported chocolate block may or may not contain milk products. When the block does contain milk, dry whole milk is reportedly the major dairy ingredient. According to chocolate manufacturers, a typical milk chocolate composition is, by weight, 45 percent sugar, 19.5 percent cocoa butter, 12.5 percent chocolate liquor, 0.3 percent lecithin, and 22.7 percent dry whole milk. In terms of the value of the block, the milk content could represent the highest percentage of the cost, because a pound of dry whole milk costs more than a pound of sugar.

Neither USDA nor the Customs Service compiles statistics on the total amount of dairy ingredients in imported chocolate block. Therefore, we had to estimate the dairy content of the 67.4 million pounds of chocolate block imported in 1988. The major importers told us the amounts of milk solids in their chocolate block. Customs Import Specialists at the two major ports of entry and a few Customs Service laboratory reports on imported block verified the milk content to some extent. The amount of chocolate block entering each port was based on Bureau of Census data.

On the basis of this information, we estimated that about 31 percent of the imported chocolate block contains 22 percent dry whole milk (or about 20.8 million pounds); about 1.5 percent contains an average of 18 percent dry whole milk (or about 1 million pounds); and about 28 percent contains no dry whole milk. We were unable to obtain information on the milk content of the remaining 39 percent of the imported chocolate block because it came from many importers at several additional ports of entry throughout the country. However, because the milk content of the import must range between 0 and 32 percent to be classified as chocolate block, we used that range for the remaining portion of our estimate and we assumed that it was dry whole milk.

From the estimates we computed the amount of dry whole milk that would likely have been contained in the chocolate block imported in 1988. This computation is shown in table 2.1.

Table 2.1: Amount of Dry Whole Milk in Imported Chocolate Block for 1988

	Pounds of imported block (millions)		Percent of dry whole milk, by weight		Pounds of dry whole milk (millions)
	20.8	x	22	=	4.6
	18.9	x	0	=	0.0
	1.0	x	18	=	0.2
	26.7	x	0 to 32	=	0.0 to 8.5
Total	67.4				4.8 to 13.3

On the basis of the above computations, we estimate that the amount of dry whole milk contained in the imported chocolate block in 1988 could range from 4.8 million pounds to 13.3 million pounds. This estimate represents a range of 3 percent to 8 percent of the domestic production of dry whole milk in 1988.

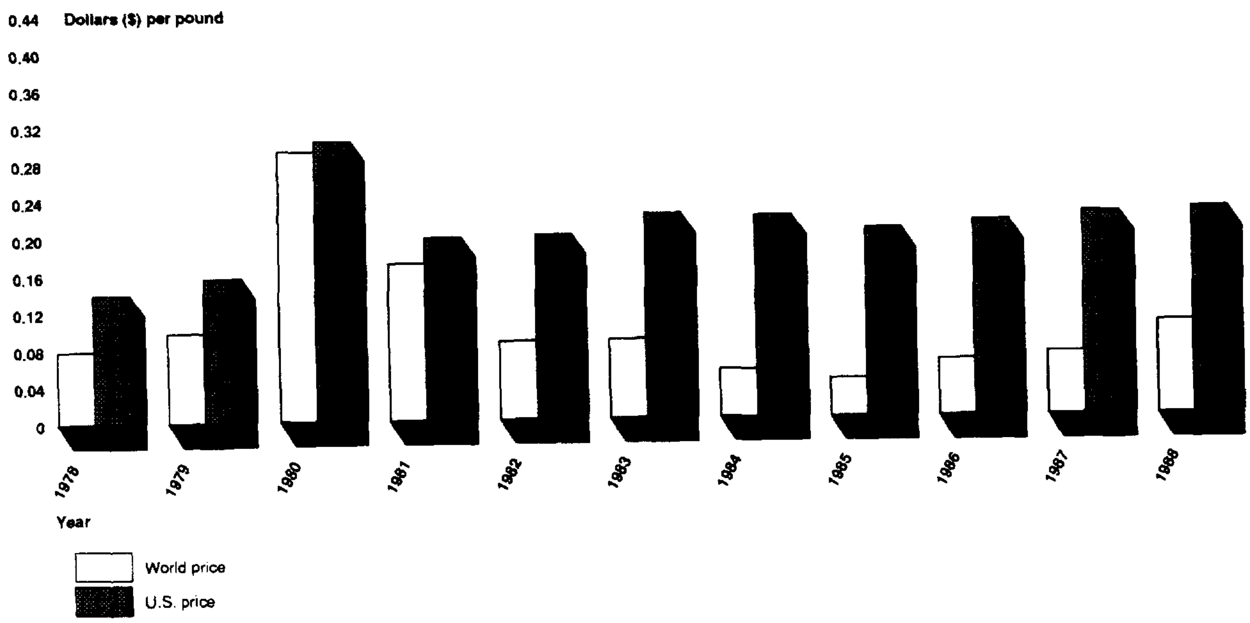
REASONS FOR THE INCREASE IN IMPORTED CHOCOLATE BLOCK

Dairy organizations and importers of chocolate block provided us various reasons for the increase in imported chocolate block. Dairy groups said the increased imports were due to the availability of lower-priced foreign ingredients that enter the United States through quota-free chocolate block. Importers gave additional reasons, such as assured availability of world supplies. The following section provides more details on these reasons.

World Prices

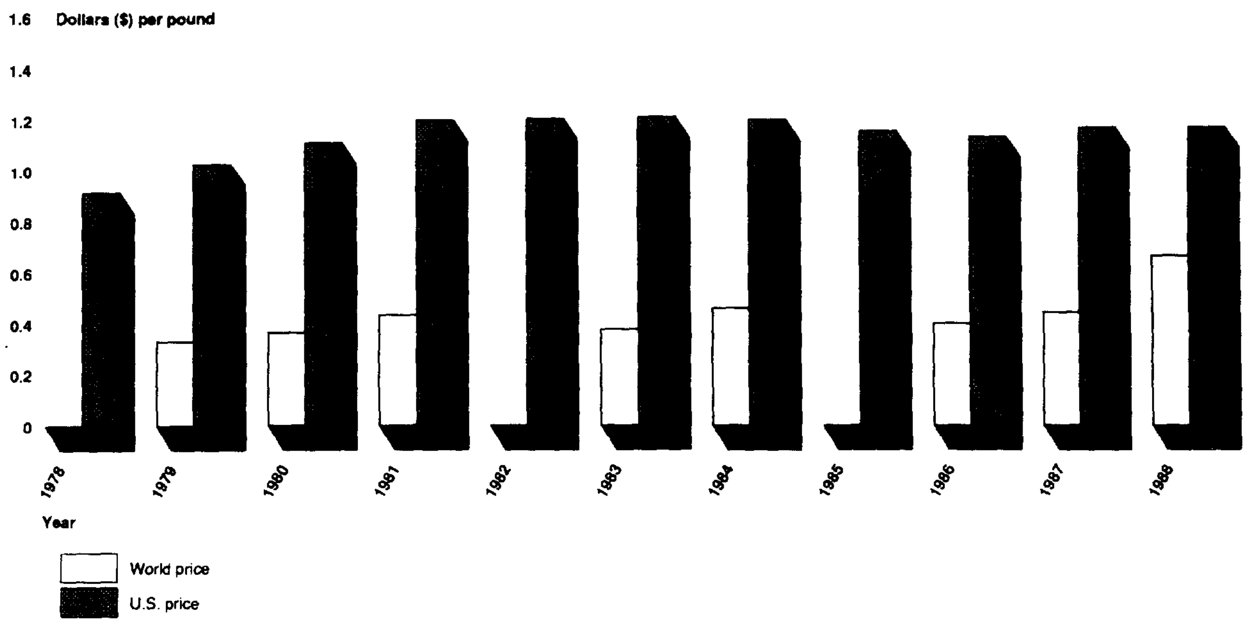
Two dairy groups that requested a section 22 investigation of imported chocolate block, the American Dairy Products Institute and the National Milk Producers Federation told us that the growth in imported chocolate block is due to the fact that major ingredients for sweetened chocolate (sugar and dry whole milk) can be purchased on the world market at or below U.S. market prices. Further, these ingredients can enter the United States without limits as long as they are contained in chocolate block. Figures 2.2 and 2.3 show the difference between U.S. and world prices of raw sugar and dry whole milk, respectively, from calendar years 1978 through 1988.

Figure 2.2: Trend in World and U.S. Raw Sugar Prices



Source: Compiled from USDA data.

Figure 2.3: Trend in World and U.S. Dry Whole Milk Prices



Source: Compiled from USDA data.

Note: World prices are not available for every year.

In 1988, the average U.S. price for raw sugar was about $0.22 per pound, while the world price was about $0.10 per pound, a difference of $0.12. At the same time, the average U.S. price for dry whole milk was $1.17 per pound, while the world price was $0.67 per pound, a difference of about $0.50 per pound. Higher domestic prices for these two commodities are due to the price support programs and quotas limiting sugar and dairy imports into the United States. By purchasing sugar and dry whole milk at the 1988 average world price, we estimate that a chocolate block manufacturer, using 45 percent by weight of sugar and 22 percent by weight of dry whole milk, could have saved $0.54 and $1.10 per pound, respectively, for a combined savings of $1.64 per chocolate block.[1] This savings represents approximately 46 percent of the total cost of these ingredients if purchased at U.S. prices.

The calculations used to arrive at our estimates are shown in table 2.2. We point out, however, that the mixture of ingredients may vary from block to block, and prices of sugar and dry whole milk may differ from day to day. Therefore, these estimates can only be used as one example of potential savings from purchasing ingredients at world prices.

<u>Table 2.2: Estimated Savings Using World Price Sugar and Dairy Ingredients in a 10-Pound Chocolate Block</u>

Step	Calculation
1	45% sugar x 10 = 4.5 lbs.[a] of sugar per 10-lb. block
	22% dwm[b] x 10 = 2.2 lbs. of dwm per 10-lb. block
2	4.5 lbs. of sugar x $0.12 per lb. savings = $0.54 savings
	2.2 lbs. of dwm x $0.50 per lb. savings = $1.10 savings
	$0.54 + $1.10 = $1.64 total savings
3	4.5 lbs. of sugar x $0.22 per lb. U.S. price = $0.99
	2.2 lbs. of dwm x $1.17 per lb. U.S. price = $2.57
	Total U.S. sugar and dwm in a 10-lb. block = $3.56
4	$1.64 savings / $3.56 U.S. cost = 46 percent savings

[a]lbs. = pounds.
[b]dwm = dry whole milk.

<u>World Supplies and Other Reasons</u>

Major chocolate manufacturers and importers told us that they import chocolate block for various reasons in addition to the cost savings associated with using world supplies. They further stated

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[1]Although chocolate block contains refined sugar, we used raw sugar prices in our comparison because world prices of refined sugar were not readily available.

that they did not believe that imported chocolate block circumvents U.S. dairy quotas.

In Detroit, Michigan, where about 30 percent of the chocolate block entered the United States in 1988, the Customs Service Import Specialist said that only one company was importing chocolate block. The president of that company said imported chocolate block does not circumvent U.S. dairy quotas because there is no tariff or quota on chocolate block, which is allowed to contain up to 32 percent milk solids. He stated that his imported chocolate block generally consists of about 22 percent dry whole milk and he imports chocolate block for several reasons:

- -- The company mixes raw ingredients to form chocolate block in a Canadian port to ensure that it has access to varied world supplies of sugar and dry whole milk to meet the needs of its customers. The supplies of sugar and dry whole milk may be purchased from various nations. Access to world supplies, according to the president, allows his company to maintain its production levels throughout the year.

- -- The company requires access to all dry whole milk markets to enable it to obtain enough of a particular type of product to meet the taste requirements of certain chocolate manufacturers.

- -- Access to world supplies allows the company to produce more efficiently if or when shortages occur.

- -- The company provides the confectionery industry with a less expensive product, which ultimately is passed on to the consumer at lower prices.

Another company, importing through St. Albans, Vermont, where about 30 percent of the chocolate block entered the United States in 1988, cited several other reasons for importing chocolate block. (According to the St. Albans Customs Service Import Specialist, this is the only company importing chocolate block at that port). The president of the company said that his imported chocolate block did not materially interfere with the U.S. dairy price support program, nor did it circumvent U.S. dairy quotas because very little of his chocolate block contains dairy products.

According to the president, chocolate block is imported into the United States from his company's plant in Canada to his company's plant in St. Albans. The St. Albans plant remolds the imported chocolate block and sells it as chocolate chips for retail sales, for example. The president said the company began to increase shipments of chocolate block through the St. Albans port in the mid-1980s as a measure to reduce the company's tariff costs. Before 1984, the company imported chocolate in liquid form, which is classified under a different tariff schedule item from chocolate block and which had a 5-percent tariff rate. In 1984, the company switched to importing its semi-sweet chocolate in solid form, as chocolate block, because no tariff was imposed.[2]

The president said that his company will not import chocolate block from Canada in a few years because, under the Free Trade Agreement of 1988, the 5-percent tariff for liquid chocolate will be reduced annually, starting in 1989, until it reaches 0 percent in 10 years. In about 3 years, according to the president, his company will revert to importing semi-sweet chocolate in liquid form because the savings derived from the tariff-free chocolate block will no longer cover the added cost of transportation and processing the chocolate in solid form.

A third company provided us additional reasons for importing chocolate block. The senior vice president of a large U.S.-based chocolate manufacturer said his company imports some chocolate block to take advantage of special production factors in the company's U.S. foreign plants. These special production factors include the use of unique production processes not available in the company's U.S. facilities and the ability to balance capacity among the company's various U.S. and foreign facilities during seasonal fluctuations.

According to some of the chocolate manufacturers and importers we spoke with, increased imports of chocolate block have benefited domestic chocolate manufacturers. These manufacturers and importers said that domestic chocolate companies are now able to produce more finished retail chocolate items rather than import them.[3] These officials also said that the rise in imports of chocolate block has helped them meet manufacturers' need for an intermediate product that can be used for making retail products.

IMPACT ON DOMESTIC PRODUCERS OF DRY WHOLE MILK

Historically, the United States has created about 2 percent of the annual world production of dry whole milk. While about 30 percent of the world production is traded among nations, U.S. production is primarily used for domestic consumption. Generally,

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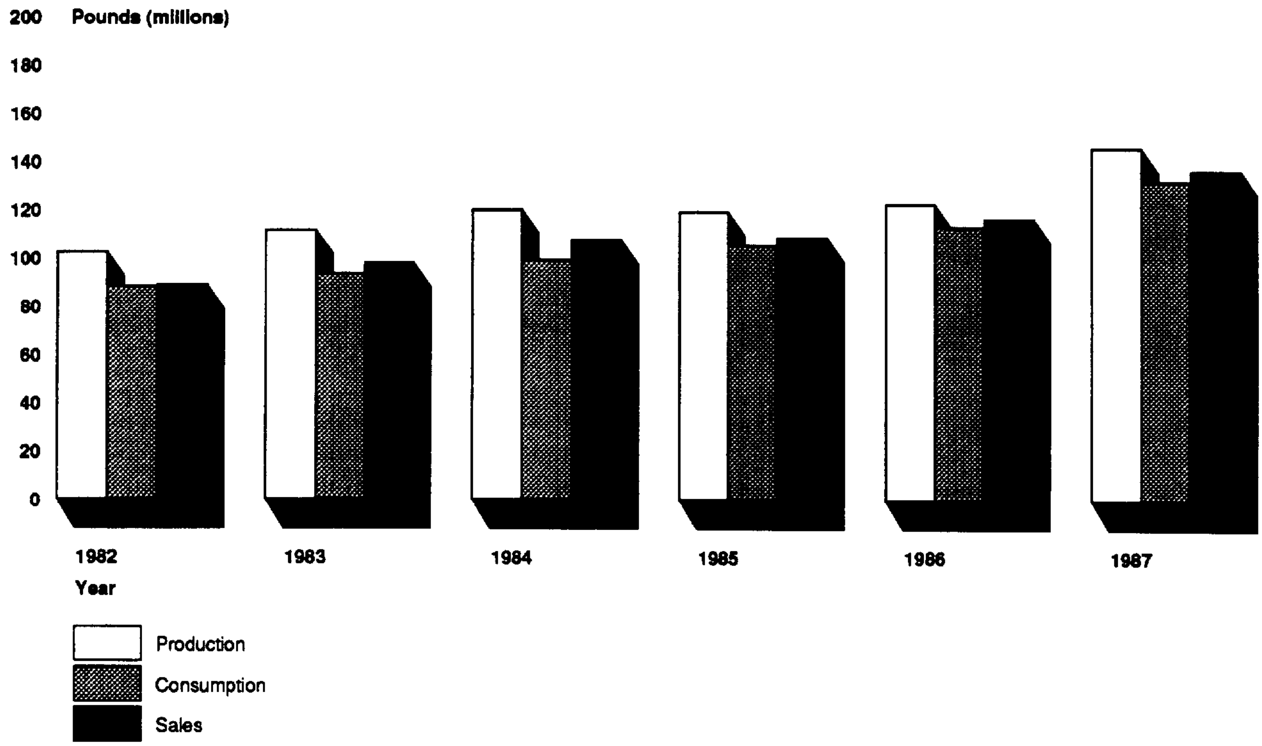
[2]Census Bureau data show that in 1984 a major increase in the import of chocolate block at St. Albans occurred while imports of liquid chocolate declined.

[3]Bureau of Census data show that in recent years the trend toward imported retail chocolate has declined while domestic shipments and exports of U.S. retail chocolate products have increased.

more than 89 percent of the domestic production of dry whole milk has been sold to the confectionery industry. Other users include the bakery, dairy, and infant food industries.

U.S. production, consumption, and sales of dry whole milk have increased in the past several years. Figure 2.4 shows the increases that occurred from 1982 through 1987.

Figure 2.4: U.S. Production, Consumption, and Sales of Dry Whole Milk



Source: Compiled from USDA and industry data.

Note: Data not available for 1988.

A key indicator in determining whether the import of a product is adversely affecting the U.S. domestic industry would be either a decrease in production or an increase in production with corresponding increases in carryover stocks or inventory. Carryover stocks have generally stayed constant at about 6.2 million pounds from 1982 to 1987, which indicates that stocks are not piling up but are being absorbed by the market.

While U.S. production, consumption, and sales of dry whole milk have increased, similar increases in imported dry whole milk may nevertheless cause some adverse impact on individual dry whole milk manufacturers. In a request to USDA for a section 22 investigation, the Executive Director of the American Dairy Products Institute expressed a belief that domestic sales of dry whole milk would have increased more if chocolate block were not imported for the confectionery industry. According to data compiled by that organization, among the 10 domestic manufacturers of dry whole milk (including 4 that produced it exclusively), 3 manufacturers experienced losses in sales between 1984 and 1986. The dairy organization attributes those lost sales to the increase in imported chocolate block. According to the president of a Detroit, Michigan, company that manufactured only dry whole milk, his company lost 35 percent of its business because a confectioner, whom he supplied, began buying imported chocolate block. The president said the importer of the block offered more competitive prices. Despite his reported loss of sales, the president provided us data indicating that his company has since regained about 7 percent of its 40-percent lost sales.

IMPACT OF IMPORTS ON THE DAIRY PRICE SUPPORT PROGRAM

Dry whole milk is not one of the dairy products directly covered by the dairy price support program because the CCC purchases only excess nonfat dry milk, butter, and cheese. Therefore, if imports containing dry whole milk interfered with the price support program, they would do so indirectly (i.e., they would not directly displace a dairy product that is purchased by CCC). Nevertheless, according to the American Dairy Products Institute and the National Milk Producers Federation, there is a significant relationship between rising imports of chocolate block and the cost to the government. Officials from these organizations believe that the import of dry whole milk in chocolate block displaces U.S.-produced milk that could be made and sold commercially as dry whole milk. Because of the imports, additional domestic milk has to be converted to a form that is purchased by CCC (e.g., nonfat dry milk, butter, and/or cheese), according to the dairy groups. They stated that

> ". . . more than 19.5 million pounds of dry whole milk, with a milk equivalent of approximately 150 million pounds, were imported into this country during 1986. . . . This displaces equivalent amounts of domestically-produced dry whole milk and increases quantities of dairy products, specifically butter and nonfat dry milk, purchased by the CCC under the dairy price support program. Our estimates of the resulting product displacement and additional dairy taxpayer cost of the dairy price support program due to unrestricted

sweetened chocolate imports . . . amounted to $26.5 million in calendar 1986."

To arrive at this calculation, the American Dairy Products Institute and National Milk Producers Federation assumed that (1) all imported chocolate block contains dry whole milk at 32 percent, by weight; (2) there is a direct displacement of CCC-purchased butter and nonfat dry milk; and (3) CCC would purchase all of the displaced dairy products.

In determining the impact of imports of specific products on the dairy industry, the International Trade Commission has at times used the concept of milk equivalency. The milk equivalent of a quantity of a particular dairy product is the amount (pounds) of whole milk it would take to produce the product. Using the concept of milk equivalency and the figures we obtained during our review, we estimated the potential impact that imports of chocolate block could have on the dairy price support program. On the basis of the statements of importers' limited Customs Service verification of the milk content of block, we estimate that in 1986 the potential cost for CCC to purchase the additional milk products (on a milk equivalent in terms of fat solids, which is estimated by USDA at 7.162 pounds per pound of dry whole milk) could have ranged from $4.3 million to $9.8 million. For 1988, the cost to CCC to purchase the additional milk products could have ranged from $4.1 million to $11.4 million.[4] On a per pound basis, this equals about 0.3 percent to 1 percent in additional purchases for 1988.

We provided our cost estimates to the American Dairy Products Institute and the National Milk Producers Federation for their comments. They stated that even if a lower cost estimate based on the statements of importers is correct, they still believed that chocolate block should be subject to a section 22 investigation because of its dry whole milk content.

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[4]In our estimates, we assumed 100-percent displacement of U.S.-produced dry whole milk by the dry whole milk in chocolate block. If the displacement were lower, the effect on program purchases would be lower. Since we were unable to determine the dairy content of a portion of the chocolate block imported at ports of entry other than Detroit, Michigan, or St. Albans, Vermont, we estimated that chocolate block entering the remaining ports contained a range of 0 to 32 percent dry whole milk, because the milk solids should have ranged between those amounts. According to our estimates for all of the block, the dry whole milk contained in imported chocolate block ranged from 6.4 million to 12.3 millions pounds in 1986 and from 4.8 million to 13.3 million pounds in 1988. Further, our estimates are based on a USDA average cost of $0.13 per pound for the milk equivalent purchases in 1986 and $0.12 per pound in 1988.

SECTION 3

CUSTOMS SERVICE EFFORTS TO ENFORCE DAIRY LIMITS IN IMPORTED CHOCOLATE BLOCK

SUMMARY

- Customs Service is responsible for enforcing quotas and collecting revenues on imports, including dairy products and dairy-containing products.

- Customs Service has in recent years concentrated its inspection and laboratory analysis on what it calls "high-risk" items.

- While chocolate block has not been considered a high-risk item, it has received some attention from the Customs Service, in part, because of increasing congressional interest.

- From fiscal year 1980 to mid-April 1989, Customs Service records indicate that 101 shipments (2 percent of the total 5,365 chocolate block shipments) were analyzed.

- Chocolate block is a minor amount of all imports at the two major ports where it enters the United States.

CUSTOMS SERVICE'S ROLE IN ENFORCING QUOTAS

The Customs Service is responsible for enforcing quotas and collecting revenues on imports, including dairy and dairy-related products. When imported goods arrive within the boundaries of the United States, their arrival must be reported to the Customs Service. From 1842 to the early 1980s, the Customs Service policy was to inspect a portion of every importer's shipment. In 1981, the Department of the Treasury amended the regulations relating to the examination of imported merchandise to allow the Customs Service to establish systems whereby only "high-risk" shipments would be physically examined by inspectors.[1] Other shipments may be released without physical examination.

According to the Assistant Commissioner of the Office of Inspection and Control, the Customs Service complies with the 1981 regulations by focusing its efforts on high-risk merchandise in its examination, testing, and entry programs. This is necessary, he said, because of significant increases in imports without corresponding increases in staffing. Chocolate block is not considered a high-risk item, but it could become one, according to the Director of Customs Service's Regulatory Trade Program Division, if the Customs Service found a problem with the product shipped by a particular importer. For example, if the Customs Service found a discrepancy indicating that an importer incorrectly labeled a shipment as chocolate block, the importer could be subjected to pay a tariff, which would depend on the correct classification of the item. In some cases, misclassification of an item, including chocolate block, could lead to a fine and more intense inspections for the importer.

EXAMINATION OF CHOCOLATE BLOCK

Although chocolate block is not considered a high-risk item, it has received some attention. In June 1988 and March 1989, the Customs Service advised its field personnel that chocolate block must be sampled for laboratory analysis on a periodic basis. The Director, Regulatory Trade Programs Division, said that the June 1988 instruction was sent because of congressional interest in the importation of chocolate block and its potential impact on sugar quotas. Similarly, the March 1989 transmittal was sent because of continuing congressional interest. According to the Director, the instructions were not necessarily intended to intensify sampling of chocolate block, but they were to serve as a reminder to Import Specialists at ports throughout the nation that, at their

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[1]According to Customs Service officials, "high-risk" items may include several factors, such as high-quota and high-tariff items or items imported by new importers.

discretion, they should sample chocolate block. The 1988 instructions said chocolate block should be sampled because it is tariff- and quota-free, and the possibility of misclassification definitely exists if the product does not meet the criteria established for chocolate block. The present criteria--which resulted from Food and Drug Administration standards of identity, judicial decisions, and administrative rulings--state that chocolate block is

-- a preparation of ground cocoa beans,

-- with or without added cocoa fat,

-- with or without flavoring or emulsifying agents,

-- with no more than 60 percent by weight of sugar,

-- with no more than 32 percent by weight of butterfat or other milk solids, and

-- in the form of blocks or slabs of 4.5 kilograms or more.

If a sample, after laboratory analysis, is found not to meet the criteria for chocolate block, the affected product must be classified as another tariff schedule item, such as an edible preparation or retail chocolate candy. The most likely alternative classifications are subject to tariffs of 5 to 10 percent, but generally, they also are not subject to import quotas. Chocolate block is not subject to the quota on dry whole milk, according to the Customs Service, because dry whole milk is commodity-specific, as are all quota provisions, while chocolate block contains a mixture of ingredients.

From fiscal year 1980 to mid-April 1989, Customs Service records indicate that 101 shipments (2 percent of the total 5,365 chocolate block shipments) were sampled. Customs Service officials said that they typically sample about 1 or 2 percent of shipments for an item that is not in the high-risk category.

The Customs Service provided us 70 laboratory reports that examined the dairy content of shipments labeled by the importers as chocolate block.[2] As table 3.1 shows, 41 percent of the samples

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[2]Customs Service laboratories did not analyze the dairy content of a few samples. Also, not all of the samples appeared to be chocolate block. For example, two samples contained no cocoa. In addition, the laboratory reported that one sample was too small to make a determination about its contents. No information on the number of samples or shipments in 1983 was readily available because the laboratories changed to a different reporting system that year, according to the Director, Operations Division, Office of Laboratories and Scientific Services, Customs Service.

contained no milk solids and six of the shipments exceeded the allowable amount of 32 percent milk solids. The six shipments arrived before fiscal year 1982. Customs officials said that those shipments could have been retested and found to have milk solids within the acceptable limit, or if the importers made errors in those cases, the laboratory results would have led to proper classification and to the payment of any applicable tariffs.

Table 3.1: Results of Customs Service Laboratory Analyses of Chocolate Samples, Fiscal Year 1980 to March 1989

	Number of samples	Percent of milk products
	6	> 32
	8	23 to 32
	18	15 to 22
	9	1 to 14
	29	0
Total	70	

Source: Compiled from Customs Service data.

Among the samples analyzed from Detroit, Michigan, and St. Albans, Vermont, where 60 percent of the chocolate block entered the United States in recent years, none of the samples exceeded the 32-percent milk limit. Customs Service Import Specialists at these two ports told us that when the importers initiated shipments of chocolate block in the early 1980s, the Customs Service conducted intensive inspections and found no discrepancies. Consequently, the Customs Service reduced the number of inspections and laboratory samples taken from later shipments of chocolate block.

From 1986 to March 1989, Customs Service documents show that 5 samples were taken at Detroit and 11 samples were taken at St. Albans. None of the samples from either port exceeded the 32-percent milk limit. In fact, at St. Albans, none of the samples contained any milk product.

In addition to these samples, we asked each of the Import Specialists at the two ports to sample a shipment of chocolate block when it entered the United States and provide the samples to us. We subsequently submitted the samples to the Customs Service laboratory in Washington, D.C., for analysis. The Customs Service reported that their laboratory analysis of those two samples showed that the Detroit sample contained 15.4 percent milk solids and the St. Albans sample contained no milk solids.

Although the majority of imported chocolate block comes from the two ports mentioned above, chocolate block is not the major commodity shipped through either port. The Import Specialist in Detroit said that chocolate block entering the United States through his port constitutes less than 0.5 percent of all his import entries. At St. Albans, chocolate block constituted about 4 percent of the total import entries in 1988. Both Import Specialists said that high-risk items receive higher priority for sampling than does chocolate block, although the Import Specialist at St. Albans said that sampling of chocolate block had increased at his port in 1989 because of congressional interest.

In addition to those samples sent for laboratory analysis, Customs Service inspectors frequently conduct other inspections of chocolate block to verify that it is in a solid form. At Detroit, where the sole importer and the Customs Service Import Specialist said that about 1 truckload of chocolate block entered each day, Customs Service visually inspected 1 of every 10 truckloads from November 1988 to February 1989, and they found no problems. The Customs Service Import Specialist said that this was the maximum extent to which any item would be inspected. He said that chocolate block was inspected at that level of intensity because of congressional interest.

SECTION 4

RESULTS OF A REQUEST FOR A SECTION 22 INVESTIGATION

SUMMARY

- Under section 22 of the Agricultural Adjustment Act, the Secretary of Agriculture can recommend that the President initiate an International Trade Commission investigation to determine whether an import interferes with the price support program.

- In 1987 and 1988, two dairy groups, believing that imported chocolate block materially interfered with the dairy price support system, asked USDA to seek a section 22 investigation.

- To date, USDA has not recommended an investigation of chocolate block imports. USDA has been reviewing imported chocolate block on an ongoing basis from the perspective of the sugar, rather than the dairy, price support program.

DAIRY INDUSTRY REQUESTED A SECTION 22 INVESTIGATION

Under section 22 of the Agricultural Adjustment Act of 1933, as amended, the Secretary of Agriculture can recommend that the President initiate an International Trade Commission investigation to determine whether an import interferes with the price support program. If the Commission finds that the import does interfere with the price support program, it could recommend that the President take action, such as imposing quotas on the import. In 1987, two dairy groups requested that the Secretary of Agriculture call for a section 22 investigation of imported chocolate block because of its milk content. The Secretary of Agriculture has not advised the President to call for a section 22 investigation on this matter.

In 1987 and again in 1988, the American Dairy Products Institute, which represents dry whole milk manufacturers and suppliers, and the National Milk Producers Federation, which represents dairy farmers and dairy cooperative marketing associations, asked the Secretary to initiate a request for an International Trade Commission investigation of chocolate block to determine whether it interfered with the dairy price support program. The two groups took the position that the dry whole milk contained in the increasing imports of chocolate block had materially interfered with the program. The two groups provided cost estimates to support their positions, which were based on several assumptions, including the following:

-- All imported chocolate block contains 32 percent dry whole milk, the maximum allowable milk content for this tariff schedule item. (The Director of Research, National Milk Producers Federation, told us that the federation's estimate was based on a telephone poll of domestic chocolate manufacturers, including users and nonusers of imported chocolate block. The Director could not supply us with a list of the respondents and their responses.)

-- The dry whole milk in imported chocolate block totally displaces domestic production.

-- CCC would purchase an equivalent milk product if the dry whole milk were displaced.

The dairy groups' estimates of additional costs to CCC resulting from the increases in imported chocolate block ranged from $0.7 million in 1980 to $26.5 million in 1986.

USDA's RESPONSE

In response to the 1987 and 1988 requests of the dairy groups for a section 22 investigation of chocolate block, the Acting Under

Secretary for International Affairs and Commodity Programs, USDA, stated that it was the Department's judgment that imports of chocolate block are primarily a concern from the perspective of the domestic sugar price support program. The Associate Administrator of USDA's Foreign Agricultural Service (FAS) told us that USDA continues to review chocolate block on an ongoing basis as a sugar, rather than a dairy, issue because generally only about 20 percent of the chocolate block consists of dry whole milk, while about 50 percent of the block is composed of sugar.

The FAS Administrator, using a request or other information, determines whether there is reasonable ground to believe that the imposition of import quotas or fees under section 22 may be warranted. Several FAS officials said that the FAS Administrator has the discretion to determine whether the Department should recommend that the President direct the International Trade Commission to investigate. However, USDA does not have any specific criteria for determining when the Administrator should recommend a Commission investigation. The Associate Administrator, FAS, told us that, in regard to section 22, USDA still considers chocolate block imports a sugar concern, but no determination had been reached to ask the President for an International Trade Commission investigation.

SECTION 5

USE OF FOREIGN TRADE ZONES

SUMMARY

- Foreign Trade Zones were established to encourage U.S. participation in international trade by allowing companies to bring foreign items into zones for a variety of purposes--including storage, export, and mixing--without subjecting the items to formal customs entry procedures, including compliance with tariffs and quotas.

- In 1987 and 1988, about 87,000 pounds of chocolate block and 6,500 pounds of dry whole milk entered zones. However, none of it would have been subject to applicable U.S. tariffs and quotas.

- Customs Service officials responsible for monitoring activities at the zones said they were not aware of any case in which a zone user had violated the dairy quotas.

HOW ZONES MAY BE USED

Foreign Trade Zones are secured areas geographically inside the United States but legally outside the customs territory. Such zones were authorized to encourage U.S. participation in international trade. The Foreign Trade Zones Board reviews and approves applications for zone status. Participating companies may bring goods into zones for manufacturing and other operations without subjecting them to formal customs entry. Companies may subsequently bring zone products into U.S. customs territory upon payment of applicable tariffs and compliance with other laws and regulations, including quotas, or they may export them without tariffs and other restrictions being applied.

Historically, only a small amount of dairy imports have entered the zones for blending in chocolate block or other items, according to the Board and Customs Service officials. A staff analyst at the Board said that dairy items entering zones are treated like other quota items. For example:

-- If an item, such as foreign dry whole milk, left a zone for domestic consumption, it would count toward the established quota.

-- Foreign dairy products entering the zones do not count toward the dairy quotas as long as they are stored, exported, or used to manufacture products that are exported.

-- If an item, such as dry whole milk, were mixed with other products in a zone and the final product entered the United States for domestic consumption, the appropriate tariffs and duties would apply to the product as it left the zone. The final product would not necessarily be classified as a dairy product under the tariff schedule, and its dry whole milk would not necessarily count against the quota.

DAIRY ITEMS AND CHOCOLATE BLOCK IN ZONES

According to a Foreign Trade Zones Board official, among the more than 4,000 companies operating in Foreign Trade Zones and subzones, seven companies are allowed to bring foreign goods into zones to manufacture food products. Three of the seven companies have permission from USDA and the Foreign Trade Zones Board to bring foreign milk products into the zones. However, the products manufactured in the zones with this ingredient must be exported when they leave the zones.

Since 1987, the Bureau of Census has compiled quarterly reports on entries and withdrawals. The reports indicate that in 1987 about 6,500 pounds of dry whole milk was sent into a zone. According to a Foreign Trade Zones Board official, the dry whole milk was subsequently mixed with other ingredients and exported. Also, about 87,000 pounds of chocolate block were sent into Foreign Trade Zones in 1987 and 1988, according to the Bureau of Census reports. The reports also indicated that about 45,500 pounds of chocolate block left the zones. A Foreign Trade Zones Board official said that the remaining chocolate block was probably mixed with other ingredients and left the zones as a different product. The Executive Director, Foreign Trade Zones Board said that because imported chocolate block is a nontariff, nonquota item, it would not have been subject to U.S. tariffs and quotas, regardless of whether it was sent to Foreign Trade Zones or anywhere else in the United States.

The country of origin for the dry whole milk entering the zone was New Zealand, while the chocolate block entering the zones originated from Brazil, Belgium, and Switzerland. Neither the Bureau of Census nor the Board could readily provide us with additional information to verify the zone activities because they did not compile records on such details and because the Census reports were designed to protect proprietary data of the companies.

The Customs Service is responsible for appropriately supervising the merchandise, maintaining accurate records, and ensuring the collection of revenue in the zones. Customs Service officials who reviewed the zones in 1988 said that they were unaware of any efforts by companies in the zones that would interfere with dairy quotas.

IMPORT VOLUMES OF SELECTED DAIRY-RELATED PRODUCTS

	Amount imported (thousands of pounds)				
Year	Butter substitute[a]	Milk protein concentrate[b]	Casein[c]	Dry whey[d]	Chocolate block
1982	61.7	0	153,955.4	81.6	4,217.4
1983	30.9	0	133,540.6	0	11,777.1
1984	130.1	0	160,179.0	368.2	17,972.1
1985	275.6	2,365.6	192,225.4	368.2	29,372.2
1986	476.2	1,084.7	187,666.2	4.4	61,030.6
1987	1,280.9	5,732.0	178,481.8	354.9	73,431.6
1988	1,589.5	8,507.7	135,456.4	90.4	67,406.3

Source: Compiled from USDA data.

[a]These figures represent the total imports of the item, but the amount of dairy content in butter substitutes or oleomargarine can range from 0 to 45 percent.

[b]Milk protein concentrate has been classified as a dairy product since 1985.

[c]In 1982, the International Trade Commission examined casein and said it was not materially interfering with the dairy price support program.

[d]Dry whey has a quota of 496,000 pounds.

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